EM FX Weekly

From bad to worse

Group Economics
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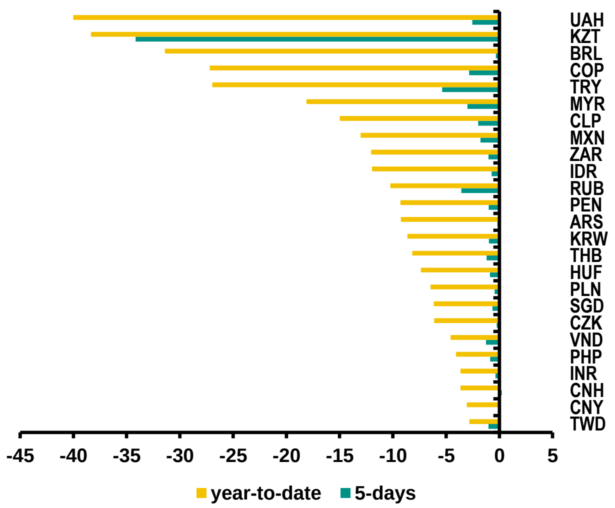
- **Sell-off in commodities drags down EM FX…**
- **…as well as risks to growth outlook and political uncertainty**
- **China's shift in FX regime has pressured others to follow**
- **More EM FX weakness ahead mainly because of the Fed**
- **The inclusion of the yuan in the SDR basket will be delayed until at least October 2016**

Sell-off in commodities drag down EM FX…

This year the performance of emerging market (EM) currencies has gone from bad to worse. What explains the fall and what happens next? One factor explaining the weakness is the substantial drop in commodity prices, which has hurt major commodity exporters (CRB has dropped by around 16% year-to-date). Renewed weakness in oil prices driven by oversupply has weighed on the currencies of oil exporters such as the Russian ruble, the Mexican peso and the Colombian peso.

Performance

In % with US dollar as basis



Source: Bloomberg

…as well as risks to growth outlook and political uncertainty

In addition, the domestic demand outlook has deteriorated in most EM economies. Risks to China's economic growth have been most in focus. This has sent ripples to the overall EM outlook, weighing on currencies. Moreover, political uncertainty has also been a major driver of weakness, for instance in the Brazilian real and the Turkish lira. The worsening fiscal and political woes in Brazil make it harder to break out of the vicious economic spiral and the risk of downgrade by S&P to speculative grade has not disappeared. Therefore, the real is one of the worst performing currencies so far this year. Only the Ukrainian Hryvnia and the Kazakhstan's tenge have weakened more. In Turkey, coalition talks broke down and early elections are quite possible. This has sent the lira to a new low this year.

Change in currency regimes?

Last but not least, the change in FX policy in China has also unnerved EM currencies, especially currencies of countries that export much to China or compete with China on third markets (see our *FX watch – Impact of yuan devaluation*). The Mexican peso also falls in this category. This week Vietnam (exporter of for example crude oil, rice and coffee) devaluated the dong for the third time this year and widened the currency's trading band. Today, Kazakhstan (exporter of oil & gas, ferrous metals and grain) decided to change its currency regime to a free-float and pursue an inflation-targeting regime. Currently, financial markets are speculating that Saudi Arabia may change its FX regime as well, creating downward pressure of the Saudi Riyal.

More weakness ahead

Overall, we expect further weakness in EM FX in coming months, especially Asia FX, the Brazilian real and Turkish lira. The start of the Fed's tightening cycle will be the main negative going forward. On the other hand, an eventual recovery in oil prices should provide some respite for the Russian ruble and the Mexican peso (as well as stronger domestic growth).

Stable Chinese yuan stabilize sentiment in Asian FX

Since 14 August, the yuan reference rate has been steady as the onshore yuan rate converged to the new reference rate. As a result, volatility expectations and the demand to hedge weakness in the yuan has subsided. This had a similar positive spill over effect on other Asian currencies. On 19 August, the IMF announced that the inclusion of the yuan in the SDR basket will be delayed until at least October 2016. This is to allow users more time to make necessary adjustments. After the announcement, yuan forwards were sold off, implying larger depreciation expectations as the potential demand from reserve managers is likely to be more subdued before the yuan is included in the SDR basket. Separately, sentiment in the Thai baht (THB) was weak after bomb blasts in Bangkok. More headwinds to the economy are likely as tourism is likely to be impacted in the near term.

CNH discount to CNY to persist into September

Next week, a gauge of China's manufacturing sector (published on 21 August) will be crucial for the direction in the yuan. A weak print is likely to increase market speculation that a weaker yuan is needed to support the economy. As a result we expect the contagion effect to impact Asian currencies negatively. The offshore yuan (CNH) discount to the onshore yuan (CNY) is likely to widen. We expect this discount to persist well into September, due to continued uncertainty surrounding China's economic growth and Fed's interest rate lift-off date. We expect corporates with foreign currency liabilities to hedge during periods when the yuan strengthens. Hence any gains in the yuan are unlikely to be sustainable. We maintain our year end yuan forecast of 6.55 against the US dollar.

ABN AMRO emerging market currency forecasts

	20-Aug	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016
USD/CNY (onshore)	6.39	6.50	6.55	6.60	6.65	6.70	6.75
USD/CNH (offshore)	6.45	6.55	6.55	6.60	6.65	6.70	6.75
USD/INR	65.4	66	66	67	67	68	68
USD/KRW	1,185	1,200	1,240	1,250	1,270	1,290	1,300
USD/SGD	1.40	1.43	1.46	1.47	1.49	1.50	1.52
USD/THB	35.63	36.00	36.40	36.60	36.80	37.00	37.30
USD/TWD	32.57	32.80	33.40	33.50	33.70	33.80	34.00
USD/IDR	13,883	14,000	14,300	14,400	14,600	14,800	15,000
USD/RUB	67	65	50	48	47	46	45
USD/TRY	2.98	2.90	2.85	2.85	2.85	2.85	2.85
USD/ZAR	12.98	12.20	12.20	12.20	12.20	12.20	12.20
EUR/PLN	4.20	3.95	3.90	3.85	3.85	3.85	3.85
EUR/CZK	27.50	27.50	27.50	27.40	27.25	27.00	26.75
EUR/HUF	313	315	320	320	325	325	330
USD/BRL	3.49	3.50	3.60	3.60	3.55	3.55	3.50
USD/MXN	16.71	15.50	15.50	15.25	15.25	15.00	15.00
USD/CLP	697	630	630	635	640	645	650

Source: ABN AMRO Group Economics